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Pilot VAT reform in Shanghai, China

China's VAT regime has undergone significant experimental reforms since the launch of the Shanghai VAT Pilot Scheme in January 2012 through a number of legislative and regulatory changes.

For many years the Chinese Government has researched and carefully considered a comprehensive reforming of the VAT system to promote the development of the service industries and to eliminate the problem of double taxation associated with the incidence of business tax on services. The Shanghai Pilot Scheme is the first step of a sweeping reform of China's indirect tax system announced in the State's 12th Five-year Plan. The program is designed to reduce confusion and eliminate the inefficiencies created by the two main types of indirect taxes - **Business Tax ("BT")** [1] and **Value-added Tax ("VAT")** [2]. Unlike BT, which is non-creditable and accumulates as it moves through the chain of service providers, VAT allows businesses to claim "input tax credits" of VAT paid on its purchases and other expenditures against VAT payable on its sales.

The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued **Caishui [2011] No. 110** (Circular 110) and **Caishui [2011] No. 111** (Circular 111) in November 2011, which set out the details of the Shanghai VAT Pilot Scheme arrangements. Circular 110, Notice for the Introduction of the Pilot Scheme to Convert Business Tax to VAT, contains the general framework of the VAT Pilot Scheme, while Circular 111 details the implementation rules and addresses specific issues in this respect.

Effective from 1 January 2012, previous BT payers in the Pilot areas become VAT payers with the following applicable VAT rates:

- Leasing of moveable and tangible goods: 17% (it was originally subject to 5% BT)
- Provision of transportation and construction services: 11%
- Provision of other specified modern services: 6%

Following the release of Circular 110 and Circular 111, MOF and SAT jointly issued additional guidance, **Caishui [2011] 131** (Circular 131) and **Caishui [2011] 133** (Circular 133) on 29 December 2011. Circular 131 announced and clarified those services eligible for zero VAT rate (mainly international transportation services) and those exempted from VAT (mainly include those services provided to foreign entities), while Circular 133 further clarifies some of the VAT pilot tax arrangement policies applicable to transportation industry (mainly on shipping agency services) and certain other modern service industries.

On 5 April 2012, SAT issued the "Announcement on Promulgating the Administrative Measures on Applying Tax Exemption, Offset and Refund on Taxable Services of Zero Value-added Tax Rate in Pilot Areas for Value-added Tax in Lieu of Business Tax" **(Announcement No. 13)**. While Circular 131 clarifies that the export of certain types of services (international transportation services, R&D services and design services) can be treated as zero-rated or exempted for VAT purposes, Announcement No. 13 sets out the documentation requirements and application procedures for claiming zero-rated VAT exemption, offset and refund for taxable services under the pilot program.

The VAT reform, if fully implemented in the whole country, will have profound impacts upon taxpayers in the whole of China. The replacement of BT by VAT will generally reduce taxpayers' indirect tax liabilities; however, it is necessary to take into consideration various factors such as the VAT rate, the tax status of the taxpayers, and the amount of input VAT available to the service providers to better understand the real changes in the indirect tax burden. The reform is a favourable change for those businesses providing services and had wasted a lot VAT input tax before the reform (because they were not VAT taxpayers and could not get a refund of the VAT tax credit), and those servicing businesses with vey little VAT input credit are now worse off. We have heard some IT service providers in Shanghai complaining that the reform should have been intended to reduce their indirect tax burden and improves their competitiveness, yet they now have to pay more indirect tax as a result of the higher VAT rate applicable to their services to clients in China and the very limited VAT input tax credit available to them, since their main costs are spent on talents and human capital (which carries no input VAT) rather than plant and machinery (on which VAT has been paid).

It is expected that companies in the transportation industry and some modern service industries (especially those providing services to foreigners) will see significant financial benefits as a result of the transition from a pure BT payer to a VAT payer, by reason of the application of exemption or zero-rate to VAT to their services. This change is expected to impact their Profit and Loss Account since BT is only a deductible cost of doing business, whereas VAT input tax would be a credit to the VAT payable on income generated from services rendered. New regulations are also creating opportunities for companies to streamline VAT operations and take advantage of special rules to recover lost VAT.

The Pilot Scheme is running smoothly with early signs of its effects evident. By the end of March 2012, 129,000 companies in Shanghai had joined the trial Scheme. It was reported that similar reforms are going to be rolled out across China with cities such as Beijing, Shenzhen likely to follow Shanghai in the near future.

[1] **Business Tax ("BT")** is a type of turnover tax imposed on the provision of services and the transfer of intangibles and immovable properties. The basic formula for the calculation of BT is: tax payable = turnover x tax rate. For most services the tax is 5% of gross service fees; the BT rates vary from 3% to 5% depending on the type of services provided (20% for the entertainment industry).

[2] **Value Added Tax ("VAT")** The standard rate of VAT for general taxpayers is 17%. There is a reduced rate of 13% that applies to some goods such as books. For general taxpayers, the VAT payable is the resulting balance of deducting the input tax for the period from output tax for the period (VAT Payable = Output VAT – Input VAT). Small businesses with an annual turnover falling below the legally defined limit pay VAT at 3%, however, no input VAT credit is allowed to these small VAT taxpayers. VAT is an important source of fiscal revenues for the Chinese Government and a major tax burden for many Chinese enterprises in the business of sale of goods.

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